DOW THEORY LETTERS INC.

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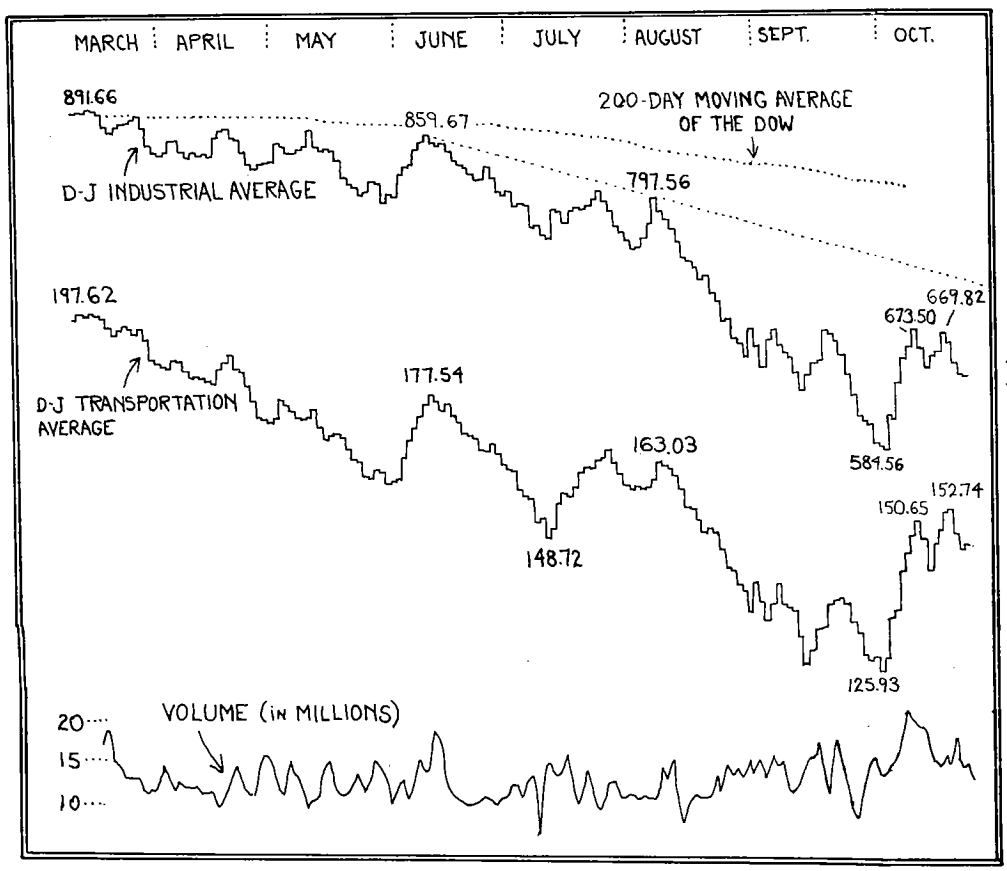
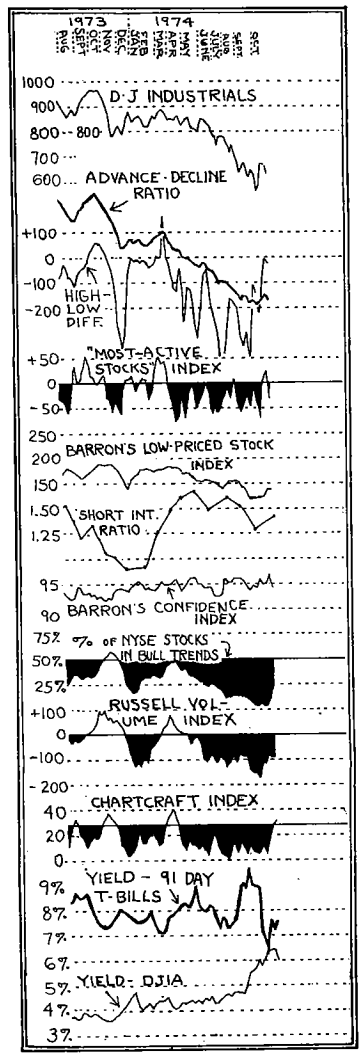
A THOUGHT: "I place economy among the first and most important virtues, and public debt as the greatest of dangers....we must make our choice between economy and liberty, or profusion and servitude. If we can prevent the government from wasting the labors of the people under the pretense of caring for them, they will be happy." - Thomas Jefferson.

THE MARKET: In this business, writers and the readers can often become so engrossed in the morning newspapers, the statistics, the pronouncements of politicians and the urgings of brokers that we forget what the whole process is all about.

For instance, the University of Michigan's Survey shows that consumer sentiment in the US has now dropped to the lowest level in 28 years. Another poll shows that 51% of the American people expect a 1930's type depression. On the factual side, consumer installment debt as of August (it is probably higher now) rose to $154.5 billion, up 50% over four years ago. Historically, whenever the consumer finds himself paying out over 13% of his disposable income for installment payments, he will automatically cut back on his spending. The August figure was 16.5%, and again it is probably higher today. So not only is the consumer way over-extended, but his purchasing power is shrinking, and he is bearish about the future.

What does that tell us? Does it tell us that the greatest spending and credit party in history is over, and that the piper is about to be paid in full? Or is it saying that the consumer is now thoroughly discouraged, and from a contrary viewpoint, the public is about to be wrong?





A friend just back from an extended trip to European financial centers sent me a copy of his very incisive notes. From Geneva, from Zurich, from Copenhagen, from Basel, from London, the story is the same. Pessimism on the part of leading bankers and financial experts. Pessimism regarding Free World leadership, the oil morass, the world debt structure, and regarding political and social trends. Could all these very knowledgeable gentlemen be right? Of course they could, but our problem as investors remains the same.

Here is our problem, stated in a nutshell. In a primary bull market, our basic problem is to determine when the market (of the averages) has discounted the best

 that lies ahead. In a primary bear market, our number one problem is to identify the area in which the market has discounted the worst that lies ahead.

One of the most fundamental facts about the market remains forever a mystery to the vast majority of investors. It is that the function of the market is to discount, to look ahead. The market (being the mysterious sum of what everyone knows about everything) is able to look ahead as much as six months to over a year. And it is this remarkable quality which confuses the average investor (and most of the professionals).

For instance, in a bear market (such as this one) the market may collapse to what seems to be "outlandish" or "crazy" levels. All of which accounts for the current Wall Street chatter about today's ridiculously low P/E ratios, the fabulous yields, the great bargains. But when we see these low ratios and prices, we can be sure that the market is looking ahead — perhaps to mid or even late-1975. At that time, today's "crazy" P/E ratios of 2 or 3 may look very correct indeed.

Ultimately, we will come to a point where a few brilliant or very lucky souls will pronounce with great trepidation that "the bottom is here." The market may go dead on low volume amid the most horrendous and shocking news. People will be saying that "Wall Street has taken leave of its senses," that the Street is insane, that "the market should be collapsing." But again, the market will be looking ahead. It will be ignoring the news of the day; it will have reflected in its price structure the worst that it can see ahead. That will represent buying time for all those who have the cash and the stomach to believe (and act on) the story being told by the Averages.

So, again I repeat that our main job is one of identification. We must try to identify the areas in which the Averages are saying (in a bull market), "This is the best we can see ahead; it's not going to get any better than this." Or (in a bear market) we must try to pick the area where the Averages are saying, "I don't care who goes bankrupt or what you read in the papers or how bad it is going to get next month, it's all reflected in the current prices and the current price structure. We (the Averages) aren't going any lower."

How do we identify these critical top and bottom areas? That's what technical analysis is all about. That's what we try to determine when we study the three phases, the odd lots, the high lows, the most-active stocks, the volume, the pattern of the Averages, the momentum indices, the prevailing psychology, the contrary opinion aspects of the situation, and so forth. The various studies are almost too numerous to mention, and in the end I find that there is one indispensible element which heavily weighs in any analyst's conclusion. It is the most unique attribute of all, and I call it intuition.

Every analyst I ever knew has tried, at one time or another, to construct an index or a system which would "give him the answer" without his having to depend on his intuition. I've never seen anyone succeed in this noble endeaver. I've never seen an automatic system that didn't fail at some crucial point, and I've never seen a man make more money than he lost in Wall Street who wasn't somehow in touch with his own intuition (for that matter, what causes you to read one market letter or listen to one broker over another, what but your intuition?).

In the last Letter I wrote that I was holding my opinion regarding the ending of the second (psychological) phase of this bear market in abeyance. I have been pondering the whole question of the second phase at length, taking into consideration the eight years' duration of the bear market so far (since 1966), the extent of the decline, the bearishness of the news now emerging, the general psychology of the public.

I will state now that I believe the second phase of the great primary bear market ended a few weeks ago at the October lows for the Averages (Industrials at 584.56, Transports at 125.93). Subscribers probably remember that the second (bear market) phase is the one in which stocks decline in response to deteriorating economic, political and social conditions, all of which are reflected in adverse corporate earnings. At present the deteriorating conditions are there for all to see, from Watergate to inflation, from the Arab oil mess to the three consecutive quarters of declining GNP, from the sliding consumer purchases to the pull-back in capital spending. All of these are characteristic of the kind of news we can expect during a great bear market's second phase.

I also believe that the upward movement which began a few weeks ago on October 4, is the movement which will separate the second phase of the bear market from the third or final phase. Following whatever highs are set by the Averages on the upward correction (and the highs may have been seen already, see page 1 chart), I believe we will enter the third phase. As I have said many times before, the third phase is the phase in which stocks go down for many reasons, but chief among those reasons is that people and institutions need to raise cash. In writing this, I realize that this third phase concept fits into the thesis which I have been predicting over the last few months. That thesis is that we have ahead of us one of the greatest liquidity crises and panics for cash ever seen. Thus, the third phase of the bear market should fit into this scenario, and stocks should be driven down to startlingly low levels as the rush for cash reaches a crescendo.

From the standpoint of the big picture, we should realize that the major advance in the Dow began in 1949 at 161.60 and continued to the (unorthodox) top of 1051.70 in 1973. This was a total rise of 890 Dow points. The pointage loss for the Dow in this bear market so far comes to 467 (1051.70 dow to the recent low of 584.56). This represents a total loss of 467 points. It also means that the bear market at the October, 1974, lows, had wiped out 52.4% of all the (Dow) gains from 1949 to the 1973 high.

A bear market loss of 52.4% for the Dow may sound like a drastic one, particularly since it occurred within a period of 21 months, but historically it is not. My expectation is that a great and highly speculative bull market such as the one which began in 1949,

should ultimately see a much greater correction than 52.4%. My expectation would be for a bear market correction of nearer two-thirds than a half, but that is, of course, only a guess. At any rate, a two-thirds correction would take the Dow to around 300, rather than the 584 figure seen at this year's bear market low.

Now, I will be the first to say that 300 sounds quite unbelievably severe, perhaps too much so, considering the terrible damage which has already occurred in the non-Dow stocks. Therefore, I will also concede that the final third phase low for the Dow could occur perhaps halfway between the second phase low of 584.56 and a two-thirds correction level. Such a level comes out to 442. So much for this week's guesses and estimates, based on history, intuition, facts, fantasies and technical considerations.

One factor which we might consider here is the one of economic weight and momentum (no, this is not a lesson in physics). For decades each contraction in the American economy has been held to minimal proportions by the sheer size of the upward momentum of the US economy. If housing slumped, capital spending was increasing. If autos had a bad year, rising soft goods sales and higher military spending took the edge off the recession. All the while, an expanding money supply kept the whole ball rolling along. Of course, the greatest factor of all was the tremendous underlying force of the primary bull tide.

Now the gears are all reversed. The momentum of the US economy has turned down, the primary trend has turned down, and all sectors of the economy are turning down together. Against this, the Government will probably pit its most potent weapon, an expanding money supply (or attempts in that direction). I don't think it's going to work. I don't think people or corporations are going to spend the money. I don't think Mr. Ford, Mr. Simon, the whole Congress and all the finance ministers of the Free World are going to be able to turn this bear market around. We're about to enter the period of debt liquidation, a toppling of the credit structure, a fight for economic survival among nations. I hate to write this way, but what good is a pack of lies and a bundle of fervent hopes. My subscribers pay me to write what I think, I'm doing it.

The survival policy I urge for subscribers is roughly the one which I have been advocating all along. This is 25% to 40% of assets in gold-related items (gold coins and gold shares) with the rest in US Treasury bills. This is in line with the idea of a panic for cash coming up, followed by a later panic for real money or gold.

I want to elaborate a bit about the first possibility or the panic for cash (gold in a later section). As I see it, business (worldwide) is turning sour, consumer spending is shrinking, high-ticket items (appliances, autos, houses) are in a declining sales trend, and the battle for corporate survival is beginning. This forthcoming fierce competition will lead to (1) a general resistance to higher prices, (2) lower sales volume, and (3) collapsing corporate profits. When profits disappear, the towering debt structure will exert the big squeeze. This will in turn set off a panic for cash (cash in order to stay solvent). So great will the cash need be, in fact, that in the face of sliding business I expect interest rates to turn up again.

These will be the underlying factors behind the third phase of the bear market, the final liquidation for Wall Street. The ultimate market lows will come (as they always do) with no hint of a bottom in the economy. There will be no green flags waving, no announcements from the New York Stock Exchange, no fanfares from the White House, no consensus from the advisory services. It will be under these frightening conditions that Dow Theorists will be accumulating common stocks. It will be an area which I believe will represent one of the greatest buying opportunities of our lifetime. That's one of the good things that I see ahead.

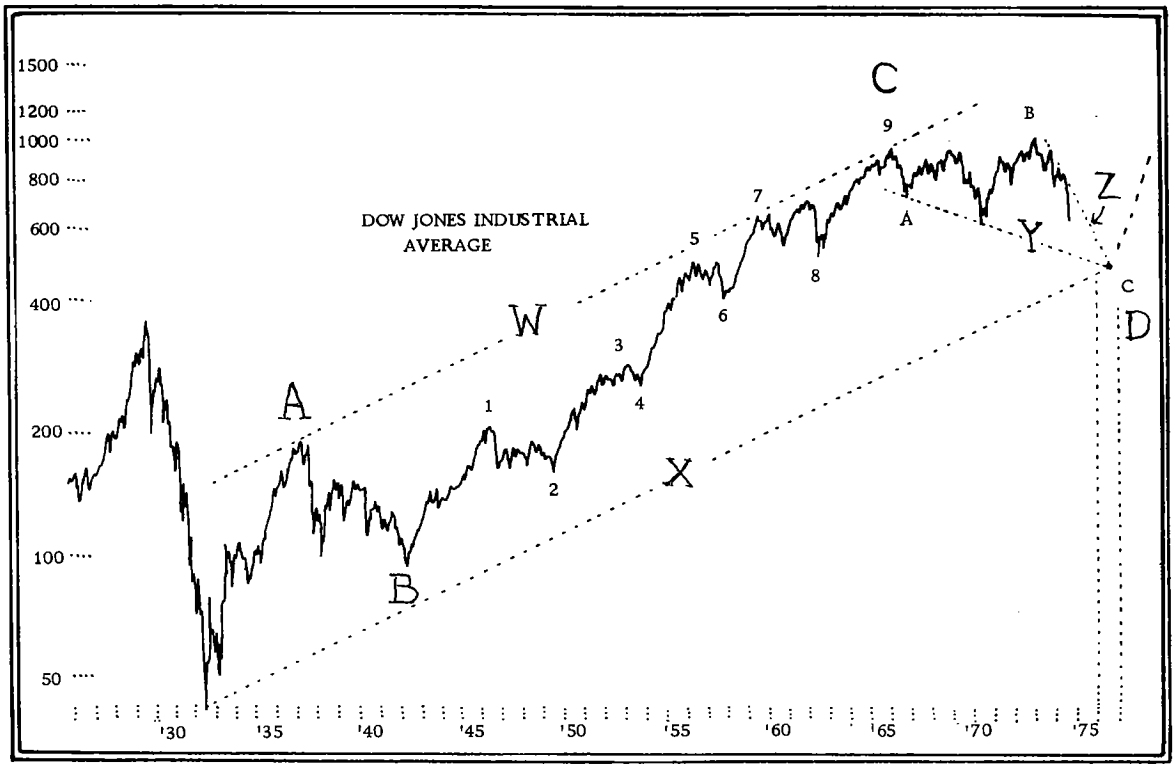
A REMARKABLE ELLIOTT PROJECTION: A few days ago Mr. A.J. Frost of Canada sent me his market projection, based on his unique and brilliant Elliott Wave studies. I have redrawn the chart (page 4) which Mr. Frost sent me, and I feel that the whole Frost interpretation is so interesting that I want to include it in this Letter. Readers may refer to Letter 607 for a fundamental discussion of Elliott (extra Xerox copies, $2).

For the edification of new subscribers, I consider Mr. Frost to be the foremost authority on the Elliott Wave Principle in the world. Frost worked with the late, great Hamilton Bolton and between them they literally revived interest in this study (first put forth by R.N. Elliott in his Financial World articles of the late-1930's). I corresponded with Bolton during the 1960's, and Mr. Frost has been kind enough to send me his various updated interpretations of Elliott.

I am not at this time going into another detailed study of Elliott except to say that according to the Wave Principle bull movements occur in a series of five waves (three up, and two corrective waves down), while bear movements occur in a series of three waves (two up-waves separated by a major downward correction).

The chart shows the Dow Industrials in its tremendous upward thrust or bull movement from 1932 to the present. As Frost interprets it, we have seen two major bull waves so far, leg A (1932-37) and leg C (1942-66). We have seen one completed bear leg so far, leg B (1937-42), and we are currently in the second corrective bear leg (leg D), which began in 1966 and is still in force.

Frost projects current leg D to extend into 1976 (longer than most analysts expect) but to terminate in the area of the 1955-56 highs of around 520 (this is a bit shallower than most of the dyed-in-the-wool bears expect). Frost sees the current bear market (major leg D) as an A-B-C "flat" correction, which should terminate at the point at which three important trendlines intersect. How these trendlines are drawn on this semi-log chart is clear enough. The top trendline (W) of the great channel intersects the 1937



and the 1960 and 1966 peaks. The lower channel trendline (X) is drawn parrallel to trendline W and starts from the 1932 low. A third trendline (Y) connects the 1966 and 1970 bottoms. And the most recent trendline (Z) runs through the 1973-74 peaks.

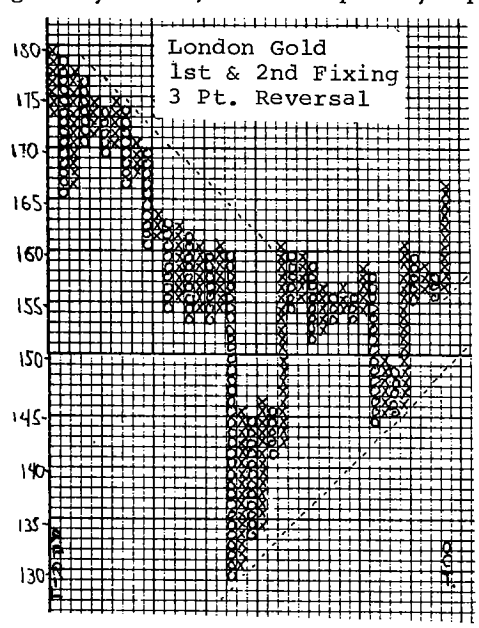
Following the end of the current bear market (leg D), Frost expect a final or fifth upward leg (E on chart), and leg E should complete the great super-cycle which began in 1932.

The question may be asked, "What do I think of all this?" My answer is only that I think it is fascinating, and if it comes to pass it is hopeful. It flies in the face of the concept of a coming extended, great depression, although it does not discount the idea of hard times for the next few years (if the market bottoms out in 1976, the economy will probably not hit bottom until late-1976 or 1977).

It is also possible, in view of the fact that many unweighted averages of all stocks have dropped 85%, that this market may back and fill, rally deceptively, then decline, and in general become totally erratic until the final bottom in the Dow. Such action would provide all the players with additional losses, even if the Dow is to sink no lower than an ultimate 520. Business could turn very bad, the public mood could turn black, and it is possible that over the next year or so the majority of stocks could just be sitting, sliding further or slowly building bases.

What could be the basis for the final leg E of the super-cycle? Perhaps a giant upward revaluation in gold, perhaps some kind of world agreement on oil, energy, food, etc. But all of this is in the realm of overworking the crystal ball, so I should probably stop here (with many thanks to Mr. A.J. Frost).

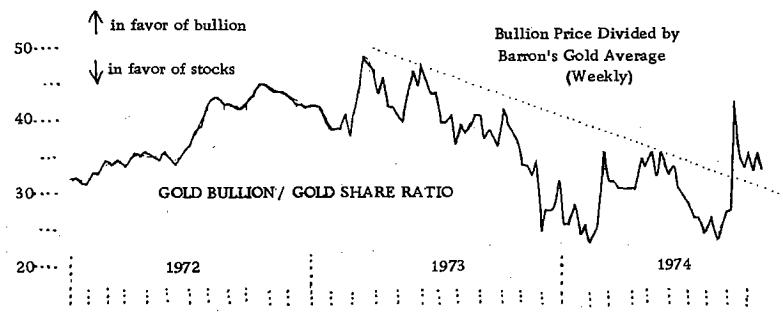
GOLD: The trouble may have been signalled by the extraordinary and continuing strength in the Swiss franc, which has now advanced to a six month high against the dollar. The French franc and the German mark are following the Swiss franc up. Why the rise in major European currencies against the dollar? Do Europeans know what we know, that the US is talking anti-inflation while they are acting reflation? Of course they do! That's why money is moving out of dollars into the strongest currencies again (note: the US money supply rose by $1 billion last week).



In recent Letters I have drawn attention to the price structure being built by London gold. After recording its all-time high of 179.50 (April 3, 1974), gold dropped to a July 4 low of 129. Since then, it has pushed into the 160 area three times, and I have shown this on the point & figure chart which is included here. On October 24 the gold price shot up to 162, thereby bettering all peaks back to June, and providing a most bullish breakout signal. For the record, my "count" on this P & F chart shows a minimum expectation of $220 for gold. I would guess this mark could be achieved before the end of the first quarter, 1975. (The P & F count is a sort of technical exercise; it fascinates me, but it obviously doesn't have to happen). P & F chart courtesy of subscriber Strebler, Imperial Beach, CA.

From all parts of the globe people are writing, "What's behind the gold move?" I have a standard answer: "More buyers than sellers," Actually, I feel that it is probable that petrodollars are now moving into gold bullion, Swiss francs, perhaps silver. Of course, when anything from IBM to Arizona land moves up a notch, everyone screams, "The Arabs are coming." This is a bit absurd, but I have felt that the Arabs would sooner or later sour on US and Western stupidity and opt for gold. Put it this way, if you were the financial guiding light of the Arab world, and you were taking in billions of deteriorating dollars every month, would you hedge with gold or not? You would? Well, I would too.

I am also including my ratio-scaled chart of gold and silver, both of which continue in flawless bull market trends. Since the chart is ratio and deals in percentages of advance or decline, the movements of both metals can be accurately compared (note the remarkably similar angle of both rising trendlines). Interestingly, gold has been walking up a secondary and steeper rising trendline as shown. Last week's jump in bullion served to keep this bullish secondary trendline intact (when even a sideways movement in gold would have broken it).

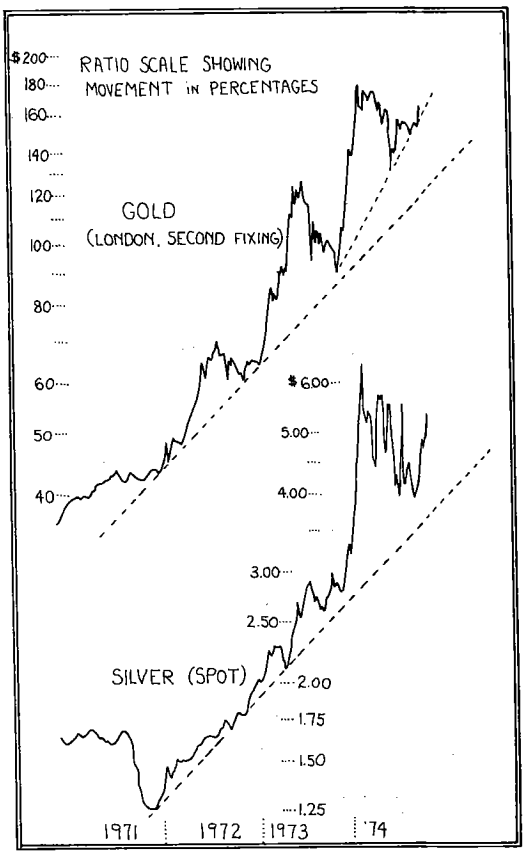


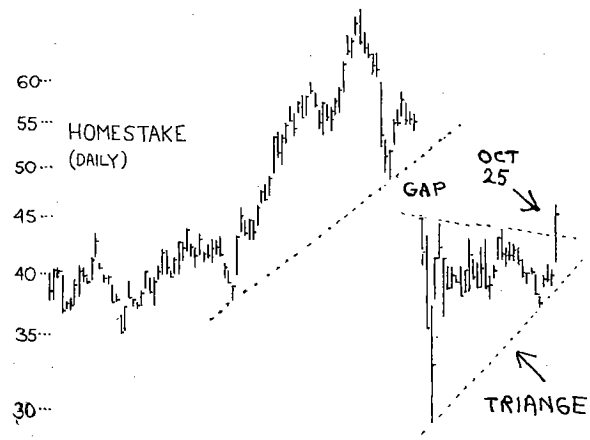
In Letter 611 I discussed my bullion/gold share ratio. Last week (as of Monday, Oct. 28) with bullion and Barron's Gold Average jumping to 167.50 and 499.5 respectively, the ratio registered 33.5 (see chart above). With the ratio moving sideways over the past five weeks, the implications are that both bullion and the shares are moving up in gear. This is actually a relative strength chart comparing gold and gold shares. So far, you're doing as well (generally speaking) with the shares as you are with gold (coins). If and when this situation changes, the chart will show it.

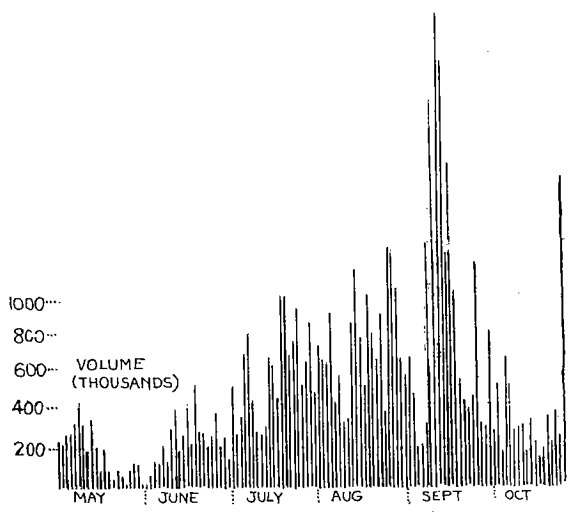
The gold shares have all staged good recoveries from their early September panic lows. Many such as ASA, Campbell, Dome, West Driefontein, Blyvoors, Vaal Reefs, President Brand, Pres. Steyn, and on and on have recovered better than half their panic losses. This, of course, is a technical plus, and implies a test of the old highs. The total gold short position on the NYSE for October was 268 thousand, down slightly from September's record 300 thousand, but still far too many shorts to be betting against a bull trend. Giant Yellowknife on the Amex has 236 thousand shorts alone, and here the shorts have been getting absolutely slaughtered.

My ratio-scaled chart of Homestake shows a most remarkable pattern. Following the panic break (note huge "gap"), the stock formed a large symmetrical triangle. On Oct. 25, HM broke out of the triangle on the upside on big volume. This move could propel HM a goodly distance towards the old high, but as we get nearer the old 69 peak, HM will probably have to pause and do "more work" (consolidation). If HM gets over the 50 level, it will have made upbetter than half its panic losses, and that's a technical gold star.

I use HM because it was the speculative leader on the big 1974 rise. Speculative leaders often take the biggest beating when profit-taking time arrives, and HM was no exception. That is why it will be crucial to watch HM now and to scrutinize its action from here on. If bullion continues to act well,

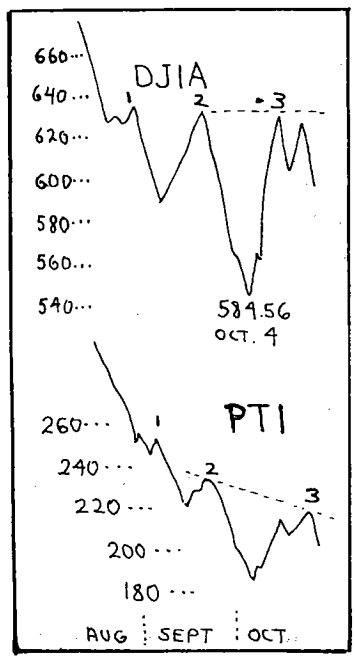






perhaps moving to or well over the old $179.50 peak, the action of the gold shares will be very significant. Many will probably go to new highs, some will not. I feel (this is a seat of my pants feeling) that we may be going into the last move on gold shares and gold bullion. How big it will be or how long it will last I do not know. One thing I will be watching is the gold momentum chart shown in the last Letter. When the current uptrend in gold bullion momentum breaks (on a trendline basis), I will inform subscribers. I will also (if I feel then as I feel now) recommend cashing in a good portion of gold shares.

Remember, every series of events is ultimately fully discounted by the market. The gold situation will be no exception, and we will have to be utterly ruthless with ourselves when the technical situation says "careful." No tree grows to the sky, no movement lasts forever, nothing, said Albert Einstein, is infinite except space and human stupidity.



LATE MARKET NOTES: (Oct. 28): I ended up the last Letter with the warning to "watch for a non-confirmation by Industrials or Transports if the Averages try to advance through the October 14 highs." The Averages did try, Industrials failed to confirm the Transport recovery highs, and down we went as shown on the page 1 chart of the Averages.

I can't (at this time) tell if this upward secondary is over, but the Primary Trend Index (PTI) is not producing good readings (see chart). Since late August we have had three almost parallel peaks on the Dow (numbered on chart), but the PTI has been fading with each successive peak forming below the last peak. This implies a steady loss in technical strength for the market, and I therefore consider the action of the past few months bearish and indicative of continuing distribution. The cumulative most active stock index on Oct. 28 hit a new low for the bear market, and here again the indications are bearish (see Letter 601 for more on this valuable index). I am aware that most of Wall Street has been calling for a big rally to carry through into 1975 (many have announced the birth of a new bull market). My work shows that the uptrend which began on October 4 is in trouble already.

NOTES & QUOTES: For months Wall Street has been drooling over the prospect of lower interest rates and loan demands. Now they're both here, with the banks dropping the prime by quarter-steps (trying to get as much mileage out of the news as possible). But it's all discounted by today's market, and the same tune isn't going to bull the market again. In fact, now that interest rates and loan demands are sinking, Wall Street has stopped kidding itself. Both of these phenomenons are symptomatic of recession, and as I've said so many times before, this recession is not going to be bullish for stocks.

The October 12 London Economist headlines an article, "Worse Than 1931," and the piece goes on to say that the world is now "under-reacting to the threat of slump." The Economist feels that nations do not understand the deflationary impact of the oil producers' balance-of-payments surplus, and it also states "that each nation now seems to be assuming that it will increase its exports more than it imports." The Economist says that Britain needs to expand its export in a world where trade is contracting. But the Economist see "no prospect of growth in exports."

I am reprinting this piece from the Swiss Economic Viewpoint, an excerpt from an article by Nicholas L. Deak, President, Deak & Co. I thought the three paragraphs included here could not be more descriptive and educational:

Increasingly, knowledgeable and responsible spokesmen in Europe are talking of what could be described as the coming oil catastrophe. Export prices of crude petroleum are currently 535% of 1972 prices. As a result, this year alone, the twenty major industrial countries which make up the Organization for Economic Cooperation and Development (O.E.C.D.) will rack up balance of payments deficits totalling $40 billion. The total worldwide cost of crude oil imports will increase from $35 billion in 1973 to an estimated $135 billion in 1974. On the receiving end, by the end of 1974, the 13 countries belonging to the Organization of Petroleum Exporting Countries (O.P.E.C.) will have boosted their reserves of gold and foreign currencies in their treasuries to $75 billion. If current trends were to continue, by 1977 this would rise to $250 to $300 billion — an amount substantially in excess of total world gold and foreign currency reserves as of year-end 1973.

Clearly this is either an impossible or a wildly inflationary prospect requiring, at minimum, a doubling of world currency reserves in only 2 years time and — again at minimum — a quadrupling of world money supplies in only 2 years. Obviously, without even taking into account other factors that point in the same direction, this is worldwide hyperinflation, pure and simple.

The figures don't add up. It's either impossible or catastrophic, for everyone, depending on how one interprets these figures. Governments are wringing their hands and clinging to a faint hope that the trends pushing the world restrictions to prevent their own wealth from leaving the country. They subsequently discontinued these restrictions and now they have been introducing restrictions to keep out foreign capital in order to be able to maintain an orderly economic growth within their countries. Restrictive measures, however, restrict the economy, restrict the growth, and restrict initiative.

AUTOS: In Letter 564 (May 23, 1973) I published a chart showing relative strength for the Auto group going back to 1912. I showed how, during the entire period of 1912 to 1973, the Autos had outperformed the market on a relative strength basis. Then, in 1973, for the first time, the entire pattern was broken. I wrote that "the market is saying that the Auto stocks 'have had it' for years to come." At that time GM was around 70, Chrysler was about 30, Ford was in the 60's. The whole sad story is now coming to pass, even though it was not visible (except to the market) in May, 1973. I expect 1975 to be a fiasco for the auto industry.

THIRD PHASE: The adverse economic news that is making today's headlines has undoubtedly been discounted by the market, and thus I feel the second phase of the bear market is ended. What has not (in my opinion) been discounted is the effects of collapsing corporate profits in the face of a towering debt structure. No one has ever seen this combination in this magnitude on a national and international scale before. That should represent the bear market's third phase.